

NUDGE TOWARDS FORMALISATION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Industry & Services Sector incl. MSMEs and PSUs

A new process of classification and registration for small businesses took off on July 1. The enterprise or the “Udyam” as it is termed under the new Udyam registration process will register itself online based on self-declaration. As of October 1, the MSME ministry has confirmed that over 7 lakh registrations have taken place using the new system. While the number of registrations could rise in the coming months, at present this accounts for 1.1 per cent of the total estimated 6.3 crore MSMEs that exist as per the National Sample Survey 73rd Round (2015-2016).

The endeavour to digitally register MSMEs is not new. In 2015, the government notified the Udyog [Aadhaar](#) Memorandum (UAM), an online filing system for MSMEs. The registration process was free, paperless and awarded instant registration. It was based on the self-declaration and self-certification of basic information regarding the enterprise’s existence and functioning. As of January, 86 lakh MSMEs had registered on the UAM portal — 13.5 per cent of the MSME universe. In 2016, the government notified rules under which MSMEs had to furnish information relating to their enterprises, online, in an MSME databank. As of January, only 1.6 lakh units registered on it.

Reliable and updated information regarding small businesses in India is absent. A dedicated census for this salient sector was last conducted 13 years ago in 2006-2007. Basic information regarding MSME units is scattered across various databases such as the UAM, MSME Databank, and GSTN. The first two datasets contain self-certified, voluntary information provided by a fraction of MSMEs whereas the GSTN has a statutory requirement that only businesses with a turnover of more than Rs 40 lakh need be registered on it.

Comparing the requirements of the UAM and Udyam registration, it is clear that the importance of generating a verified database of MSME units has been acknowledged. Under the Udyam registration process, Aadhaar is made mandatory for proprietors whereas companies/LLPs must provide their GSTIN and PAN along with the Aadhaar number. Moreover, every enterprise can have only one Udyam Registration Number, irrespective of the number of manufacturing and service activities provided. The self-declared information regarding investment and turnover is verified using the integration of the Udyam system with the Income Tax department database and the GSTN. For classification and information updation purposes, therefore, the registering entity’s ITR, GST returns and PAN will serve as reliable information. Entities that have previously registered (as of June 30) on other portals/systems will continue to be valid until March 31, 2021.

By this cut-off date, however, it is expected that they will re-register themselves under the Udyam registration process. In an attempt to nudge more enterprises to become lifetime Udyam, the government has integrated the system with the Trade Receivables Electronic Discounting System (TReDS) and the Government e-Marketplace (GeM). Such linkages significantly benefit MSMEs by offering a free and automatic route to onboard bill discounting mechanisms and the government’s online procurement system.

In its updated Priority Sector Lending (PSL) guidelines, the RBI has established that for the purposes of PSL, MSMEs will be identified as per the gazette notification laying down the new process of classification and registration. It has also clarified that all lenders may now obtain the Udyam Registration Certificate from entrepreneurs. It is clear that going forward financial institutions can make the Udyam registration a prerequisite for lending purposes.

It is important to understand how this will bode for a vastly informal MSME sector. These unincorporated small business units comprise self-employed/owner-managed firms with characteristic features of household enterprises and those that operate with less than five workers. Most of these firms are not formally registered anywhere for various reasons. They are so small that they bypass minimum thresholds that require them to pay income tax or be registered under the GST. Being invisible benefits these firms since it enables them to stay out of a rather complex and expensive regulatory apparatus. The costs of formalisation and compliance are high and onerous in many states in India. In such an ecosystem, there are perverse incentives to remaining small and informal.

From April 1, 2021, it seems that the Udyam registration may be the only valid proof for an entity to be recognised as an MSME as per the revised definition. While the Udyam initiative holds more promise in terms of capturing reliable and verified information about MSMEs, it is important to assess if this will be detrimental to some of them in terms of accessing formal finance. The slightest chance of the Udyam registration turning into an entry barrier must be rectified before April 2021. To this end, the government and RBI should consider whether the registration requirement can be exempted for units with investment and turnover that falls in the lower end of the criteria that presently defines micro-enterprises, for the purpose of accessing formal credit.

In 2018, the International Finance Corporation estimated that the overall supply of finance from formal sources met only one-third of the credit demand of the MSME sector. These businesses prefer relying on informal sources for financing due to their inability to meet documentation protocols, inadequate collateral, disorganised book-keeping, among others. Enabling strategies such as PSL could provide a fillip to priority sectors including MSMEs which require increased formal financing. It is imperative that such institutional lending initiatives continue to remain accessible for all businesses, formal and informal, and deliver on the promise of financing for inclusive development.

Pandey and Pillai are fellow and research fellow, respectively, at NIPFP. Views are personal

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